S. HRG. 100-655

INTERMARKET FRONTRUNNING AND OTHER FINANCIAL MARKET MANIPULATIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

THE PRACTICE OF FRONTRUNNING [THE PROCESS OF A BROKER TAKING ADVANTAGE OF HIS KNOWLEDGE OF A CLIENT'S ORDER FLOW TO TRADE FOR HIS OWN ACCOUNT]

APRIL 20, 1988

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

84-767 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

5241-23

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WILLIAM PROXMIRE, Wisconsin, *Chairman*

ALAN CRANSTON, California
DONALD W. RIEGLE, JR., Michigan
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
ALFONSE M. D'AMATO, New York
CHIC HECHT, Nevada
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
JOHN H. CHAFEE, Rhode Island
DAVID K. KARNES, Nebraska

KENNETH A. MCLEAN, *Staff Director*
LAMAR SMITH, *Republican Staff Director and Economist*
ROBERT A. JOHNSON, *Chief Economist*
BARTLETT C. NAYLOR, *Chief Investigator*
GILLIAN GARCIA, *Director of an Economic Analysis Group, GAO*
STEVEN B. HARRIS, *Staff Director, Subcommittee on Securities*

CONTENTS

WEDNESDAY, APRIL 20, 1988

	Page
Opening statement of Chairman Proxmire	1
Statements of:	
Senator Dixon	3
Senator Sasser	5
Senator Sanford	7

WITNESSES

Robert G. Kirby, chairman, Capital Guardian Trust Co., Los Angeles, CA	9
Complete prepared statement	11
Roland M. Machold, director, Division of Investment, State of New Jersey	14
Complete prepared statement	15
Panel discussion:	
Example of damage by frontrunning	25
Identifying the major transactors	26
Policing intermarket manipulations	28
Robert A. Kanter, managing partner, Arbco Limited Partnership, New York, NY	30
Complete prepared statement	33
Victor Sperandeo, general partner of Hugo Securities Co	44
Complete prepared statement	47
R. Steven Wunsch, vice president, Kidder, Peabody and Co., New York, NY	50
Complete prepared statement	51
Panel discussion:	
Program trading	56
Stopping exchange of information	57
Prohibit trading on material market information	58
Block traders	60
Automated order match systems	62
Value of circuit breakers	64
Advantage of the electronic stock market	65

INTERMARKET FRONTRUNNING AND OTHER FINANCIAL MARKET MANIPULATIONS

WEDNESDAY, APRIL 20, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:00 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, and Garn.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The Committee will come to order.

This morning we examine market manipulation, a problem that was highlighted by the October 19th crash.

Playing too fast and too loose is no stranger to Wall Street, as we will hear today. Frontrunning is where a broker trades ahead of a customer and that's running amuck. At the Chicago Board of Options Exchange in 1986 there were 54 reviews of frontrunning, in 1987 there were 36, in 1988 to date 8. Of these, 40 are still open and 2 have resulted in penalties.

The futures pits suffer the same problem. In the Chicago Board of Trade in 1987 where the Major Market Index is traded, there were 127 reviews of frontrunning allegations resulting in 4 actions, with 3 more pending. So far in 1988, 35 reviews have been initiated.

What's more, the real frontrunning problem is cross-market where the broker takes a futures position on knowledge of a stock trade. Because of split regulation, there is no direct surveillance of this problem. We can only guess the magnitude of this unpoliced profit-making scheme. It's probably enormous.

Who's the victim? The victim is the investor who takes the other side of the options trade or the futures contract. That investor loses money. Institutional investors whose every trading decision will move the market are clear victims. The pensions they manage are being quietly looted. Pricing accuracy is also under siege. After taking a position in options or futures, the firms will execute the trade so as to maximize, not minimize, the stock price change. Eventually, the integrity of the entire market is undermined.

Frontrunning is petty theft compared with the organized crime of market manipulation. Because futures prices act as a billboard for stock prices, heavy trading in the futures market could create a false signal for the stock market. We've heard serious allegations

of manipulation on Terrible Tuesday, the day the markets nearly died. What happened on this day? According to some, a cabal conspired to buy heavily in the Dow connected futures market in Chicago leading to a jump in stock market prices. That may have saved the day, but it burned the investors who took the other side of trades and, if true, it underscored the violence of manipulation.

Now the very saddest part of this debacle is that it may be legal. Former Attorney General Nicholas Katzenbach was commissioned by the New York Stock Exchange to study the problem. He's come to the conclusion that our laws are incomplete. In broad terms, intermarket manipulation highlights the conflict when firms act for customers at the same time they trade against them.

The fact is that since 1982 securities firms have made more money trading for their own account than on commissions from trades for customers. So far we've depended on ethics to police our markets. Unfortunately, that's no longer good enough. Trust that verifies, our President advises, in dealing with the Soviet Union. If there ever was an argument for intermarket surveillance, coordination, that's it.

Our witnesses today include two noted institutional investors, Robert Kirby of Capital Guardian Trust Company, a member of the Brady Commission; and Roland Machold, who manages the $20 billion pension fund for New Jersey State Employees.

Before you gentlemen testify, I'm delighted to recognize our ranking member and former chairman, the distinguished Senator Jake Garn.

Senator GARN. Thanks very much, Mr. Chairman. I have no opening statement.

The CHAIRMAN. Before we begin, I have statements from Senators Dixon, Sasser, and Sanford to insert in the record. So without objection they will be placed at this point.

[The information follows:]

APRIL 20, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
INTERMARKET FRONTRUNNING AND OTHER
MARKET MANIPULATION ISSUES

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE SENATE BANKING COMMITTEE CONDUCTS OVERSIGHT HEARINGS ON INTERMARKET FRONTRUNNING AND OTHER FINANCIAL MARKET MANIPULATION ISSUES. WE HAVE A GOOD GROUP OF WITNESSES TESTIFYING BEFORE US TODAY, AND I LOOK FORWARD TO THEIR TESTIMONY.

ONE OF THE FOUNDATION STONES OF OUR FINANCIAL MARKETS IS THE PERCEPTION THAT THEY ARE FAIR -- THAT THE PRICES ARE REAL MARKET PRICES. MARKET MANIPULATION UNDERMINES THAT FUNDAMENTAL PRINCIPAL AND CAN CAUSE INVESTORS TO LOSE CONFIDENCE IN OUR MARKETS. IT IS THEREFORE IMPERATIVE TO ENSURE THAT OUR FINANCIAL EXCHANGES AND THEIR REGULATORS HAVE THE TOOLS THEY NEED TO DETER

MARKET MANIPULATION IN THE FIRST PLACE, AND TO DETECT IT AN PROSECUTE IT IF AND WHEN IT DOES OCCUR.

I AM PLEASED TO BE ABLE TO SAY THAT THE FUTURES EXCHANGES IN CHICAGO HAVE THE BEST MARKET SURVEILLANCE SYSTEM IN THE WORLD. THEIR SOPHISTICATED, COMPUTERIZED SYSTEM PROVIDES COMPLETE AND TIMELY INFORMATION ABOUT TRADING ON THE EXCHANGES. IT DEMONSTRATES WHAT CAN BE DONE.

I KNOW THE CHICAGO EXCHANGES ARE INTERESTED IN IMPROVING COOPERATION WITH OTHER EXCHANGES TO IMPROVE FURTHER IMPROVE THEIR SURVEILLANCE IN THE INTERMARKET AREA. THEY KNOW, AS THIS COMMITTEE KNOWS, THAT THERE IS NOTHING MORE IMPORTANT THAN MAINTAINING THE BASIC INTEGRITY OF OUR FINANCIAL MARKETS.

Jim Sasser

STATEMENT OF SENATOR JIM SASSER, SENATE BANKING COMMITTEE, APRIL 20, 1988

MR. CHAIRMAN, I AM PLEASED THAT THE COMMITTEE IS TODAY EXAMINING THE ISSUE OF MARKET MANIPULATION, PARTICULARLY IN THE CONTEXT OF THE OCTOBER STOCK MARKET CRASH. THE COMMITTEE HAS ALREADY HEARD THAT INDIVIDUAL INVESTORS WERE SUBJECT TO DISCRIMINATORY TREATMENT DURING THE MARKET DEBACLE.

THIS TREATMENT HAS GIVEN THE EQUITY MARKETS A PERCEPTION OF BEING A DANGEROUS AND UNFAIR PLACE TO INVEST -- A PLACE WERE THE DECKS ARE STACKED AGAINST YOU. AS A RESULT, THIS PERCEPTION IS DISCOURAGING SMALL INVESTORS FROM RETURNING TO THE MARKET.

INDEED, THE ABSENCE OF SMALL INVESTORS, WHO HOLD FOR THE LONG TERM, CONTRIBUTES TO VOLATILITY. AND VOLATILITY FURTHER DISCOURAGES INDIVIDUALS. THIS IS VERY DANGEROUS "CATCH-22" FOR OUR NATION'S CAPITAL RAISING AND JOB CREATION PROCESS.

EVIDENCE OF MARKET MANIPULATION, THAT WE WILL HEAR MORE ABOUT TODAY, IS ONE MORE BLACK MARK ON THE MARKETS. TACTICS SUCH AS FRONTRUNNING AND SHORT SELLING ARE INHERENTLY UNFAIR. THEY DISCRIMINATE AGINST OTHER MARKET PARTICIPANTS. MOREOVER, THEIR MANIPULATIVE CHARACTERISTICS DISTORT THE MARKET, ADDING TO THE GENERAL PERCEPTION OF UNREALITY AND UNFAIRNESS.

MR. CHAIRMAN, I AM LOOKING FORWRD TO TODAY'S TESTIMONY. THANK YOU.

Terry Sanford

OPENING STATEMENT OF SENATOR TERRY SANFORD

OVERSIGHT HEARING ON MARKET MANIPULATION

APRIL 20, 1988

Mr. Chairman, I thank you for scheduling this hearing this morning and I thank are distinguished witnesses for their very helpful testimony.

I believe that the subject we are addressing this morning is extremely important. We heard what I found to be very disturbing testimony yesterday from representatives of the Securities Industry Association that many, many individual investors have simply left the market. A recent New York Times article quotes the head of equity trading at one firm, stating "the retail customer is out." We read troubling statistics that initial public offerings have not rebounded significantly since October and that the market's ability to serve as a means to raise capital is being jeopardized. These dangers stem largely from a sense that our market is no longer a place where the small investor gets a fair shake, that the markets are being run by a small number of large firms that can themselves

cause the market to move, and that speculation and greed have nearly taken over.

Our hearing this morning addresses one important aspect of that perception--that of front running and manipulation. If we are going to restore confidence to our markets and bring the small investor back in, I think it is imperative that we take whatever steps are necessary to ensure that frontrunning and market manipulation do not occur. Even the perception that some firms can, through frontrunning, make money for themselves at the expense of their clients, will work to keep the small investor on the sidelines. I do not think we can afford to allow manipulative practices to drive capital from our markets.

I look forward to hearing our witnesses comment on how great a problem market manipulation is and what we can do about it. It is a very serious issue that I hope this Committee will continue to examine and to address. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Kirby, as I say, is the chairman of Capital Guardian Trust Company and a member of the Brady Commission, and Roland Machold is the Director of the State of New Jersey's Division of Investment.

Mr. Kirby, didn't we meet out in California?

Mr. KIRBY. Yes, we did.

The CHAIRMAN. As I recall, you made very, very impressive testimony out there. You're obviously an expert in this area and we're delighted to see you again.

Mr. KIRBY. Thank you. I thought I had tough competition. I came in a strong second, which wasn't bad. Your speech was okay, too. [Laughter.]

The CHAIRMAN. You're a diplomat. Go right ahead, sir.

STATEMENT OF ROBERT G. KIRBY, CHAIRMAN, CAPITAL GUARDIAN TRUST COMPANY, LOS ANGELES, CA

Mr. KIRBY. Well, I believe I can make my point of view rather brief. There's a more formal statement floating around here someplace.

If you took a survey of institutional investors across the country, I think you would get a plurality of 80 or 90 percent of those who believe frontrunning is a common ongoing problem.

I think you would also find that same group testifying to the effect that under our present regulatory structure it's just going to be a topic of conversation from now on forever because it is virtually impossible to prove.

One of the things that we found so dramatically in the Brady Commission study was how difficult it was to determine who bought and who sold on the New York Stock Exchange on Monday and Tuesday. We had a staff of 40 people who stayed up until 2 a.m., an incredibly talented group of people. We had the mass might of IBM behind us with John Opel as one of the task force members. And yet I can't count the hundred manhours and the amount of political pressure and persuasion and all sorts of things it took for us to find out who bought and who sold on Monday and Tuesday.

It seems to me the solution to the problem is the one you just pointed out. We need a system whereby either an authorized regulatory body or the injured party or someone who can with relative ease determine actually what happened. If I believe I've been frontrun on some kind of an order program, it seems to me—say if I'm willing particularly to bear the expenses of the investigation—the record keeping on the New York Stock Exchange and in Chicago should be kept moment by moment on each stock reflecting who the principal was in the transaction so that if an injured party believes he's been injured you could actually pull off the records and find out whether there was frontrunning.

Frontrunning is going to take place in two forms. One where you sell in the futures market and ahead of an order flow in the cash market, but I think more particularly, the kind of frontrunning that occurs maybe deserves a different title, and it's a situation where a major institutional brokerage firm whose dossier on the way a major money manager functions is really awesome. They

know more about us than we do about ourselves I think sometimes. And rather than use that information as an estimate of what your future order flow may be, to frontrun for his own account, he's going to use that information to tip off a hedge fund manager who generates enormous amounts of commissions, far more than your traditional money manager, and it is going to be that hedge fund manager using that information that the broker may give him to frontrun you and the broker himself generates by increased commissions rather than by trading for his own account.

To summarize, we're going to go around—at least those of us in the money management business are going to go around feeling paranoid until time ceases unless there is some sort of a record keeping mechanism put in place so that an authorized regulatory structure can find out who bought and who sold. And once it's easy to prove frontrunning, I think it will go away.

[The complete prepared statement of Mr. Kirby follows:]

Robert G. Kirby, Chairman
Capital Guardian Trust Company

TESTIMONY - UNITED STATES SENATE BANKING COMMITTEE HEARING
Wednesday, April 20, 1988

Anyone concerned about the practice of frontrunning (the process of a broker taking advantage of his knowledge of a client's order flow to trade for his own account) has to acknowledge that it may well have a similarity to Big Foot or the Loch Ness Monster. All three are widespread topics of conversation and are passionately believed to exist by a segment of the population. However, in no case does there exist an accumulation of hard evidence to prove the case.

I am quite sure that a survey of experienced institutional money managers would reveal that a vast majority believes that frontrunning on the part of brokers happens with some frequency and that it happens to the detriment of their institutional clients. However, the same group of money managers would probably also acknowledge itself as a slightly paranoid lot, frequently suspicious that someone out there is tinkering with the securities they are trying to buy or to sell.

It is widely accepted as fact that the leading brokerage organizations have the ability to frontrun their clients and capture a house profit should they choose to behave in an unethical manner. There is also a widespread belief that those brokerage houses have highly ethical leaders who attempt to establish and follow sound business standards. To the extent that frontrunning occurs, most such practices are undoubtedly initiated by individuals who do not choose to honor the ethical standards of the firm.

The ability of the brokerage firms to do profitable frontrunning stems from their extensive knowledge of the behavior patterns of their institutional customers. The detailed knowledge that each major brokerage house has on the largest money management organizations is probably equal to the dossier the CIA would have on the military attache at the Soviet Embassy. The brokers know (1) the current investment strategy of each money manager, (2) whether he is positive or negative on bonds and/or stocks, (3) his attitude toward particular industries or countries and (4) his present holdings in client accounts, (5) the modus operandi that the money manager pursues when he is in the process of realigning client portfolios.

The broker can make a pretty good educated guess, when he sees sell orders of 50,000 of Ford and 50,000 of Borg Warner from a particular money manager, whether or not this is an isolated trade or the first step in a substantial reduction in his commitment to the automotive industry involving several million dollars in

sales over a period of weeks. The knowledge of such a substantial ongoing liquidation program is knowledge of great potential financial value to the short-term trader or frontrunner.

Simple frontrunning, (selling stock in the cash market ahead of a client) is prohibited by the New York Stock Exchange and is probably infrequent. The deliberate frontrunning that does take place occurs in two ways. Since there is as yet no cooperation or common standards between the futures markets in Chicago and the cash markets in New York, a customer's purchase or sale order for securities legally can be frontrun through the futures markets in Chicago. Puts and calls can be executed in individual common stocks, and index futures can be bought or sold in anticipation of large, broadly-based customer realignment of portfolios.

The second form of frontrunning is probably much more common and widespread. Technically, perhaps the process should not be called frontrunning, because the broker takes no action for his own account. Instead, he informs the manager of an aggressive trading and arbitrage pool of capital (often called a hedge fund) of his knowledge and judgement concerning the near term order patterns of a major institutional money manager. The typical hedge fund has very high portfolio turnover, often as much as 500% per year or more, and therefore generates many times the commission dollars of a mutual fund or pension fund manager with 25-50% annual turnover.

By transferring his knowledge of future order flows to an aggressive trader, the broker can sometimes achieve greater profits than he could by frontrunning the same orders in the futures markets. Further, he will have solidified a relationship with a customer who generates high commission volume.

In my judgement, the perception of frontrunning on the part of money managers as a serious problem is probably greater than the facts of the situation justify. Under today's securities markets reglations, it is virtually impossible to prove or disprove the suspicion of frontrunning. The matter is likely to continue indefinitely as a point of controversy until disclosure requirements are changed. Only then are we likely to know whether frontrunning is another Loch Ness Monster or not.

One of the most surprising (and shocking) discoveries of those who worked on the Brady Commission study was the great difficulty in getting the answer to an apparently simple question: "Who bought and who sold on October 19th and 20th?" To find the answer required an incredible array of skilled resources and a great deal of political support from The Administration. When the answer was finally obtained, the major transactors in both the futures and the cash markets turned out to be quite different than most of the commission members thought they would be.

I can think of no possible reason why information should not be easily available to an appropriate regulatory authority as to specifically who bought and who sold, at what time and what amount,

in both the cash and the futures markets. Furthermore, after a passage of a reasonable period of time, where the implementation of investment strategies are no longer likely to be disrupted, this information should also be available to the general public.

If such data were available on each security and on each option traded in either New York or Chicago on a volume and time sequence basis, frontrunning would easily be discernible. If it is a widespread problem in today's markets, it would quickly disappear. A more detailed audit trail of transactions and more complete disclosure would do more than simply deal with the problem of frontrunning. In markets that become so chaotic that they threaten the structure of the market system itself, such as we experienced last October, the general public is entitled to know who the participants were. If such a requirement had been a part of securites markets regulation last year, I do not believe the events of mid-October would have been as threatening as they were.

84-767 0 - 88 - 2

The CHAIRMAN. Thank you very much, Mr. Kirby.
Mr. Machold.

STATEMENT OF ROLAND M. MACHOLD, DIRECTOR, DIVISION OF INVESTMENT, STATE OF NEW JERSEY

Mr. MACHOLD. I'm awed by my colleague's ability to speak extemporaneously and to the point. I'm going to not speak extemporaneously and I'm afraid I'm not going to be too conclusive.

The CHAIRMAN. Your statement will be printed in full in the record.

Mr. MACHOLD. Yes.

[The complete prepared statement of Mr. Machold follows:]

Roland M. Machold

Testimony before the Senate Banking Committee

April 20, 1988

Senator Proxmire, members of the Committee, ladies and gentlemen, I am Roland M. Machold, Director of the Division of Investment of the State of New Jersey. The Division is responsible for investing 109 funds with an aggregate market value of $24.5 billion. In my capacity as director I am responsible for investing the assets of seven state administered pension plans, whose assets aggregate $19.5 billion. Of this amount, approximately half is invested in stocks in American corporations. All of the Division's assets are managed by an internal staff of about 65, including our own traders and portfolio managers. I am here to comment on the trading practices and experience of the Division of Investment, and to respond to any questions you may have.

You have specifically asked me to provide some insights into the Division's trading practices over a period from July 1986 through May of 1987, during which period the Division executed 28

sales programs and 9 purchase programs through competitive bidding procedures. The aggregate market for the sales and purchase programs was $1.3 billion dollars and $307 million dollars, respectively. These programs were initiated in order to accelerate compliance with a law passed in 1985 in New Jersey which requires the disposition of all securities related to companies engaged in business with the Republic of South Africa. In your invitation to me to provide this testimony, you indicated that you were concerned that there might have been "front-running" by brokerage firms on our programs, either directly on the various exchanges or, alternately, in the markets for index futures. I will take a moment to describe the Division's equity trading practices, and then provide more detailed information regarding the competitive bids over the 1986-1987 period.

Like many investors, the Division executes its equity trades very cautiously. On average, the Division executes about $75 million dollars of equity transactions per week, or about $4 billion dollars a year in total. This business is spread very widely amongst the brokerage community to reward for both research and execution services. Those firms chosen for their execution capability are judged through an internal merit system, which is reviewed by our independent State Investment Council. Our execution business is shared by those firms which provide timely and discrete executions, and who originate blocks of the stocks of those companies whose securities we may be buying. We do not ask any firm to take a position in a stock we may be selling, nor do we

precipitously trade large blocks of stock. All of our investment decisions are made in committee meetings held once a week and the resulting orders are given to our trading desk for execution over the ensuing week. Our traders will give a broker a portion of the week's orderfor a stock, and we will carefully monitor every single execution in the course of fulfilling the order. If the execution appears to be good, our traders may provide subsequent orders to the broker in either the same stock or in the stock another company. All of the execution sheets are reviewed by senior management, and the week's transactions are reviewed in full at each meeting of the Equity Committee.

Our usual trading procedures are designed to minimize the possibility of poor executions and the opportunity for any brokers to engage in "front-running". For one, we utilize those brokers who have excelled in our merit review over many years. Second, our individual orders are relatively small, for an institutional investor, and may aggregate no more than 5,000 to 10,000 shares at a time. Furthermore, we do not act precipitously, and in the event the markets are unfavorable, we will step back and wait for a better market. Third, we do not ask brokers to position stock for us, or in any other way assume extraordinary risks on our behalf. Fourth, our trading desk monitors every single execution, even executions of 100 or more shares out of each order. In this way, we are aware of the broker's attention to the order and the broker's interaction with the market place. In compensation for their efforts, we pay brokers commissions which averaged about 4.5 cents

a share during fiscal 1987.

However, the Division decided to change its usual practices in carrying out the mandate of the New Jersey Legislature to divest the pension funds of all stocks of companies doing business in or with the Republic of South Africa. The book value of the aggregate amount of securities targeted for divestment exceeded $4 billion dollars, and, depending upon the point of time, the market value was considerably in excess of the book value. The law provided that the divestiture must be completed within a three year period, namely, by August 27, 1988. The law and its effects were well known to the brokerage community. Furthermore, State law requires that the Division publish all of its transactions on a monthly basis. The Division's sales were not a secret to the street, and we found that our usual procedures were too slow to reach our objectives in a timely fashion. We were concerned with both the divestiture mandate and the rapidly rising stock markets, which brought us to the view that we should accelerate the divestiture program. Finally, the Attorney General of the State ruled that index options and futures were no longer legal investments for the Division, since those same indices served as market proxies for South Africa related companies.

As a consequence, the Division turned to a new program for disposing of the securities. On average, once a week, we drew up lists of targeted securities, usually about 40 in number, and auctioned them off at competitive bidding prior to the opening of

the market on the day of the auction. We would initiate the offer on one of the first three days of the week, in order to minimize the possibility of any weekend exposure to a successful bidder. We took care to vary the specific day of the bid in order to minimize the possibility that brokers would anticipate our bids.

At 8:45 a.m. on the day selected for the auction, we would contact a list of anywhere from eight to ten of those brokers who historically had provided the best executions for us. We gave them forty-five minutes to prepare a bid, which consisted of a single figure for the entire package of stocks. The amount of our aggregate offering ranged from a low of $24 million to a high of $116 million on any one day. These amounts were divided up among approximately forty stocks, so that no one stock or group of stocks tended to dominate the list. Furthermore, those companies which are targeted for divestment as a rule include the very large international corporations, which also, taken together, are fairly approximate to the broad market indices. By providing that the bids be submitted at 9:15 a.m., we permitted the winning bidder to hedge himself,if he chose,in the options markets which opened at the same time. Also, we believe that it would be more difficult for the traders to price an entire package in a moving market, and that the morning openings of the various markets would provide high levels of liquidity.

The results of the bidding program are shown on the attached exhibit. In summary, we sold $1.3 billion dollars worth of stocks in 28 bids, in every case on a net basis, without commissions. If we measure our execution costs against the closing prices of the previous night, then our programs cost about 10.6 cents per share. However, if we measure our execution costs against the market prices at the opening of the market on the New York Stock Exchange, at 9:30 a.m., then in effect we had negative transaction costs of 1.9 cents per share. The use of either benchmark must be qualified, since the closing prices of the previous day are not necessarily representative of the markets on the day of the auction, since markets have been open around the world in the interim. Furthermore, if one uses the opening prices on the day of the bid as a benchmark, then the bid itself may be reflected in the prices shown by the specialists on the exchanges.

The Division also executed 9 buy programs through competitive bidding, and the execution costs for these programs were 16.7 cents per share, compared with the previous night's close, and 3.7 cents per share compared to the opening prices on the day of the bid. The execution costs were higher for the purchase programs, because the list of stocks was composed of companies which were much smaller and had much less market float.

I cannot answer whether or not our buy and sell programs may have been subject to "front-running", either directly or through the use of index futures. While our programs were fairly large,

nevertheless, they only constituted perhaps one per cent to two percent of daily market volume on the exchanges. There are likely to be many trading programs in the market place on any one day, initiated by program traders, portfolio insurers, index arbitrageurs, and by major investors and traders. Any broker who would expose his capital on the basis of our trades would run the very considerable risk that other forces in the market place would dominate the effect, if any, of our programs. On balance, we are satisfied with the results of our trading programs. The costs, when compared with the opening prices, appear to be very fair when compared with historical costs of doing business in the usual manner. Furthermore, we achieved the important objective of accelerating the program and realizing prices which in retrospect now seem very ample.

However, there are several points which may be of interest to your committee or those who wish to study these transactions. First, there were several firms which did not wish to engage in the bidding from the outset. Furthermore, one of the major banks had indicated an interest in bidding in order to help execute transactions for their index funds, but the bank never provided a bid. Second, there were two firms who dropped out of the bidding programs over the period of time that we were going to market, and these firms were replaced by another two firms. Third, we understand from one of the winning firms that their transactions were executed on the London Exchange. Fourth, another firm who won on more than one occasion indicated that they had found that it was

to expensive for them to hedge in the futures market. Fifth, it appeared to us that most of the firms did not have within their own offices the good communications between their trading desk, their block trading desk and their index and options trading desk. Finally, during the course of our bidding program, we never heard any specific complaints from the winning bidders to the effect that other brokers were trying to disturb the market for their securities. One broker was concerned on one occasion that other brokers might be short selling against him, but this was an isolated instance, and, as far as we can see, brokers participated in our programs in a routine fashion. Competitive bidding is not welcome by brokers but is commonplace in over the counter stocks and the markets for bonds and mortgages. In conclusion, the Division was pleased with its bidding programs, even though we would prefer in normal circumstances to engage in somewhat slower and more measured trading executions in the traditional manner.

I understand that one of the concerns of this committee is the degree of coordination which should be required between the market for stocks and stock index futures and options. As you can see from my testimony,the Division of Investment attempted to achieve such coordination through the timing and design of our programs. If your investigations show that there was "front-running" between the markets, then we would like you to identify the offenders, and we will take appropriate action. In summary, we would support measures to create the closest possible coordination between the stock and futures markets.

Date	Shares	Close	Open	Proceeds	Winning Bid	Henley Group	Hen. Grp Proceeds
7/8/86	388,500	$ 23,906,875	$ 23,582,500	$ 23,850,000	Goldman	---	$ ---
7/14/86	610,000	33,830,875	33,572,500	33,624,093	Goldman	5,000	95,050
7/21/86	605,000	33,516,875	33,416,875	33,877,270	Smith Barney	10,000	173,800
7/28/86	520,000	28,168,125	28,122,500	28,255,925	Morgan Stanley	10,000	187,500
8/5/86	600,000	29,717,500	29,963,125	29,826,450*	Market	25,000	464,000
8/11/86	495,000	26,541,875	26,568,750	26,534,380	Morgan Stanley	10,000	181,500
8/18/86	860,000	46,919,375	46,817,500	46,811,825	Donaldson	20,000	382,800
8/26/86	510,000	28,656,250	28,726,875	28,681,751	Drexel	20,000	396,000
9/3/86	685,000	38,177,500	37,991,875	38,052,950	Kidder	20,000	397,600
9/8/86	785,000	43,632,500	43,470,000	43,614,476	First Boston	25,000	490,500
9/15/86	660,000	32,797,500	32,986,875	32,843,700	Drexel	20,000	363,000
9/22/86	745,000	38,265,625	38,351,250	38,302,875	Drexel	20,000	383,800
9/28/86	1,015,000	51,468,125	51,114,375	51,259,825	Pru. Bache	50,000	969,000
10/6/86	1,195,000	65,231,875	65,266,875	65,290,300	Kidder	50,000	951,000
10/14/86	1,610,000	89,643,125	89,343,750	89,229,100	Kidder	50,250	1,031,130
10/20/86	2,234,000	117,599,875	116,621,000	116,921,375	Kidder	---	---
10/27/86	530,000	27,928,750	27,928,750	27,835,000	First Boston	---	---
10/31/86	710,000	38,514,375	38,494,375	38,478,875	First Boston	---	---
11/17/86	680,000	39,540,625	39,115,000	39,365,350	Kidder	---	---
11/24/86	715,000	41,761,875	41,480,625	41,754,375	Paine Webber	---	---
Year End 12/31/86	16,152,500	$875,819,500	$872,935,375	$874,409,895		335,250	$ 6,466,680
3/9/87	1,270,000	68,773,750	68,469,375	68,439,000	Donaldson		
3/16/87	1,050,000	56,891,250	56,698,750	56,733,750	Donaldson		
3/24/87	1,250,000	71,141,875	70,915,625	70,935,625	First Boston		
4/7/87	1,045,000	60,985,000	60,889,375	60,827,000	Drexel		
4/21/87	760,000	42,973,750	42,636,875	42,744,000	Donaldson		
5/5/87	770,000	46,075,375	46,358,750	46,089,775	Drexel		
5/19/87	770,000	44,967,500	45,137,500	44,885,000	Morgan Stanley		
5/26/87	815,000	45,286,875	45,876,250	45,311,326	Drexel		
	23,882,500	$1,312,914,875	$1,309,917,875	$1,310,375,371			

* Salomon Brothers would not honor bid. Securities sold in market. Proceeds net of $45,275 commissions.

Date	Shares	Close	Open	Cost		Offerings
9/17/86	710,000	$ 23,410,625	$ 23,448,750	$ 23,446,125	First Boston	$ 23,446,125
9/24/86	845,000	32,987,500	33,067,500	33,087,500	Hutton	33,087,500
10/1/86	865,000	30,105,000	30,262,500	30,320,000	Donaldson	30,320,000
11/6/86	595,000	26,346,250	26,370,000	26,490,000	Smith Barney	26,490,000
11/13/86	1,110,000	38,092,500	38,116,250	38,203,500	Donaldson	38,203,500
11/19/86	1,055,000	39,506,250	39,422,500	39,561,495	Goldman Sachs	39,561,495
11/25/86	1,695,000	65,668,125	65,714,375	65,955,120	Goldman Sachs	65,955,120
12/31/86 Total	6,875,000	$256,116,250	$256,401,875	$257,063,740		$257,063,740
4/15/87	545,000	24,413,436	24,889,375	24,599,999	Smith Barney	24,599,999
4/16/87	545,000	25,132,811	25,405,000	25,329,062	Kidder Peabody	25,329,062
	7,965,000	$305,662,497	$306,696,250	$306,992,801		$306,992,801

The CHAIRMAN. Thank you very much, sir.

Mr. Kirby, can you please describe how an investor such as you can be damaged by frontrunning?

Mr. KIRBY. Well, really in the simple process of the price—if it's a buy order, of the average price you pay being higher as a result of someone anticipating your action.

It's hard for me to emphasize strongly enough the ability of the major investment banking firms to frontrun an organization like mine if they chose to do so. I would also hastily add that they have very ethical leadership and there's no firm out there that as a practice is going to frontrun us. I think the problem is when it occurs is that an individual within that firm chooses not to honor the ethics of the firm and to utilize the advantage of his customer's order flow.

EXAMPLE OF DAMAGE BY FRONTRUNNING

For example, they kind of know so much about us, how we think, how we execute orders, how we implement portfolio strategy, that if they see a couple of orders—let's say to sell Chrysler, Borg-Warner and Ford, they may know that we have $100 million invested in the auto industry and they've talked to enough of our people to know what this represents is a leading edge of a major move out of that industry.

Now to the extent they (1) either sell futures of automotive stocks in Chicago—and we found quickly in mid-October that action in the futures market transfers very quickly back to price pressure in the cash market—we're going to get an average price that is lower for those auto stocks when we execute it. Or there's such a thing that I think happens far more often which is——

The CHAIRMAN. Let me give you an example of what concerns me about this. In the 4 months before the Black Monday crash occurred, it's my understanding that the calculations were that a $2.5 million purchase would drive the Dow up one point. And that 4 months after, a $1.7 million purchase would drive the Dow up one point.

Now that means that if you had an order to buy $10 million of a particular stock—it could lead to a very, big increase and by the time you came in, if somebody frontran you, they could bid the stock up 10 points and it means that you would have to pay that much more for the stock. Is that an example? That may be an exaggeration, but is that roughly what concerns you?

Mr. KIRBY. Certainly it is. Probably the magnitudes are rarely that much. The frontrunner runs the risk if he moves the stock too much you're going to cease your program and therefore there won't be any safety net underneath him when he attempts to do his double flip or whatever he's doing.

But one of the things that I've thought about over and over again, and I cannot come up with a satisfactory answer, is the question, why should transactions on the New York Stock Exchange not be a matter of public record in due course? Of course, you can't release information immediately because it affects people's investment strategy that they're trying to implement in their portfolio, but why shouldn't the public be able to say who sold and

who bought on October 19th and 20th, 90 days later, or at a particular point in time?

I have this strong feeling that if the major players on those 2 days had known their actions would be a matter of public record at some time in the future, a great many of them would not have been doing what they did.

IDENTIFYING THE MAJOR TRANSACTORS

The CHAIRMAN. There's no record available, public or private, is that true? The Brady Commission, for instance, wasn't able to determine the extent of this practice by looking at the identity of the people who bought and sold?

Mr. KIRBY. Well, we didn't have time to focus on frontrunning, but the process of our simply finding out who the major transactors were in the cash and the futures market on Monday and Tuesday was a monumental effort, but we ultimately found that out, and the data we had would have allowed us to determine whether someone was frontrunning if that had been our charge and if we had had time because we ultimately found out who transacted second by second.

The CHAIRMAN. Without the information record you call for identifying precisely who made the trades, are you able to make any rough estimate of how much this practice has cost you as an institutional investor?

Mr. KIRBY. No, I don't have the foggiest idea and I doubt if anyone else does either. But the magnitudes could be really substantial, but measurement I think would be just virtually impossible.

The CHAIRMAN. Mr. Machold, could you describe what the current rules are on inter and intra-market frontrunning?

Mr. MACHOLD. We are not involved in the futures market, as you know. I'm not an expert on the rules. I'd have to ask somebody who's used to that exchange. My general knowledge of the market is that in effect the broker is obligated to execute an order in your behalf and I'm sure that firm policy, if not SEC rules and regulations, would prohibit him from in effect intervening himself in the trade and acting on his own behalf.

We ourselves obviously go to great lengths to ensure that. We don't trust any rule or regulation to do that. We select our brokers in such a way that if we see that they appear to be slovenly in the market and other people are getting lower prices while our order is still outstanding or for some reason stock is being bid up while the order is in his hands and he is executing orders at a higher price, we will do that. Now we have to examine the mosaic of every individual order to do that.

Now I digressed a little bit from your question for which I apologize, but I'm not an expert on the individual rules dealing with those. Our rules are that they have to act on our behalf. If they intervene themselves in the process and get away from the level of market prices that's evident when we place the order, then they're not going to do any more business for us.

The CHAIRMAN. Mr. Kirby, you say that you have a very strong and I think a reasonable and prudent suspicion of frontrunning but

you don't have any specific evidence because the records just aren't there.

You do take precautions I take it, because your suspicions are as strong as they are; is that correct?

Mr. KIRBY. Yes. After a while you begin to feel slightly paranoid. I think everyone who kind of runs a portfolio is always afraid somebody is tinkering with the market for things he's trying to buy or sell. So admitting we're a slightly diseased profession, I still think a great deal of frontrunning actually happens.

For example, if we put in a sell order of 100,000 shares of General Motors and there's suddenly a great deal of activity in General Motors puts in Chicago, you say to yourself, "I wonder what those guys are doing?" And you call the executing broker and say, "Are you basically active in General Motors puts in Chicago?" And his answer often will be, "Yes, but that is part of facilitating your trade. What I'm doing is reducing my risk so that you will get a better price."

But when you say, "What was the sequence here? Did you begin selling puts before, during or after you were actually selling my General Motors in the cash market or finding a buyer for it?" And there's no way to answer the question except the sequence of events occurs so often that you—you have to rely so much on our traders' estimates, but they will say, "You got a price that was below what you should have gotten under normal circumstances," but when you go from there to proving anything, it's an impossible leap and, of course, we may penalize that broker for a while and he finally convinces us it was an aberration in the marketplace and he wasn't doing anything wrong, but unless you could really find out the time sequence of transactions on General Motors in the cash market and puts in Chicago and who were the principals, you just couldn't answer the question.

The CHAIRMAN. Mr. Kirby, because of the huge number of customer orders placed over the weekend between October 16th and 19th with securities firms, the SEC reviewed evidence of firms frontrunning their customers. Specifically, the SEC reviewed trading in the S&P 500 with data supplied by the Chicago Merk. This showed that in the last hour of trading on Friday, October 16th, firms' proprietary orders were executed in seven different transactions—at least seven—at prices higher than those of customer orders. Undoubtedly, they sold at a higher level.

Then on Monday, October 19th, nine transactions involved proprietary orders, leading customer orders. While the SEC has not determined any wrongdoing, the Commission's report on the market break concludes, "that the incidence of the questionable trades argues for careful review of potential frontrunning transactions by their member firms."

Should the SEC undertake a formal investigation of frontrunning, in your view?

Mr. KIRBY. I'm not sure they would be able to prove anything and I guess I have strongly mixed views about that.

The CHAIRMAN. You say they're not able to prove anything, but if you had the kind of information requirements in place that identified the people and the time of trading, the people and the time

of trading, then they would have a basis for an investigation; is that right?

Mr. KIRBY. Yes.

The CHAIRMAN. It would have to be perfected.

Mr. KIRBY. Yes. For example, ask the question, what is wrong if a major brokerage firm shorts S&P 500 puts in Chicago aggressively early Monday morning in anticipation of an avalanche of sellers? He's frontrunning the world, but he's not necessarily frontrunning a specific customer. What happened between Friday and Monday was because of portfolio insurance programs, because of huge redemptions on some mutual funds over the weekend, there was about $10 to $15 billion of equity risk that had to be disposed of Monday morning and it was largely identifiable by a whole lot of aggressive traders. The whole world was frontrunning what obviously was going to be a tidal wave of selling.

It's not illegal. Maybe it's not even unethical.

The CHAIRMAN. You have a situation here where a brokerage firm has, as you say, an avalanche of sellers. They can see what's going to happen in the market. So they go in on their own account and they sell before that. Customers who have orders are hurt by it. I would think that about the only way you could handle that is to say brokers can't trade for their own accounts. Wouldn't that do it?

Mr. KIRBY. Surely.

The CHAIRMAN. What would be wrong with that?

Mr. KIRBY. That is the solution, but to me it should happen—we should do it.

The CHAIRMAN. What do you mean "we should do it"?

Mr. KIRBY. I mean money managers, investors out there. What we should do is say to brokers, "We're not going to trade with you as long as you trade in the same securities on a proprietary basis for your own account." But somehow we've never been able to do that.

The CHAIRMAN. You've never been able to do it. Does that indicate that what you need is action by the SEC or by some regulatory agency with legislative authority?

Mr. KIRBY. I guess I've always been kind of instinctively reluctant to do a legislative solution to a problem.

The CHAIRMAN. I think that's a healthy reluctance. At the same time, this is a very serious problem and if this is the only solution it's certainly one we ought to consider.

Mr. KIRBY. Well, I strongly believe that a broker should either act as agent or as principal. He can't do both. He should do one or the other. And it really should be the New York Stock Exchange that should say you guys can't trade for yourselves and your customers in the same securities. But, of course, the New York Stock Exchange serves its members and those guys are its members. But that is the problem right there, the firm acting as both agent and principal in the same securities at the same time.

POLICING INTERMARKET MANIPULATIONS

The CHAIRMAN. Mr. Machold, exchanges say they do police intermarket manipulation through a voluntary organization called the

Intermarket Surveillance Group. I'm somewhat skeptical of this since many exchanges are not or were not recently members.

What's your view?

Mr. MACHOLD. I've never heard of that group. As you know, our trades—the ones that I referred to in my testimony—were mentioned in an article in the Wall Street Journal. Apparently several brokerage firms themselves have said there's been some frontrunning on these trades. We never received a call from this particular group. I've never heard of them. I would have thought they might have picked it up in the press and you would have thought initiated some action, perhaps studied the trades from our end.

The CHAIRMAN. Are you familiar with that group, Mr. Kirby?

Mr. KIRBY. No, I'm not. But as far as I know, there is absolutely no legal problem with shorting a security in the futures market versus the cash market, that that sort of frontrunning is not illegal.

The CHAIRMAN. Mr. Kirby, in his forthcoming analysis of markets, writer Martin Mayer, who's a very able and wise author and expert, expresses concern that securities firms have fundamentally changed their business from servicing customers to servicing themselves.

Since 1982, firms have earned more trading for themselves than from commissions earned from trading for customers. This change coincided with the emergence of stock index futures.

I asked just a minute ago whether we should just simply prohibit brokers from trading if they're going to trade for others because there's such a blatant conflict of interest.

Is there anything short of that that we could do that would, in your view, make a real difference here and protect the investor who may be a victim of frontrunning?

Mr. KIRBY. I can't think of a solution to that problem. As I said before, I don't understand why those of us using the services of brokers don't insist on doing business with brokers who are acting as agent and not as principal. But as Mr. Machold pointed out when we were talking earlier, those firms don't have the capital that the big guys do and this change really all began with competitive negotiating commissions and by an odd coincidence by what those brokers used to make when they had 20 cents a share commissions they now make through principal transactions for their own account. Their profitability hasn't changed and we now pay 4 cents a share instead of 20 cents, but they're making the same amount of money as they did before just through different procedures.

But more responsive to your question, I don't see a solution except the buyers of brokerage services behaving in a more rational and intelligent manner.

The CHAIRMAN. Now your descriptions of the inadequacies of the audit trail in the securities market is troubling. The Brady Commission serving at the request of the President was required to go to extraordinary lengths to finally reconstruct trading information in the securities market for the period of the market break.

Under these circumstances, is it possible that the SEC is even maintaining anywhere near the level of routine oversight necessary to deter such trading practices as frontrunning?

Mr. KIRBY. I certainly don't see—I'm not really aware of what the SEC does in a day-to-day sense, but I certainly see no evidence of their having a concern for this problem. It surprised me very much to find that in the futures exchanges in Chicago there are adequate records kept as to who transacts by principal and it was fairly easy to find out there. It was virtually impossible to find out in New York. And I would suspect the SEC would probably actually have to subpoena the records of the major investment banking firms and then process them at great expense to find out who bought and who sold. And to me, records should be kept so that would be an easy thing to do.

The CHAIRMAN. So it would be just as reasonable and efficient and practical to keep records on the New York Stock Exchange as they do keep at the present time in Chicago; is that right?

Mr. KIRBY. Yes. For the life of me, I don't understand why that is not required.

The CHAIRMAN. Do you see any objection to that, Mr. Machold?

Mr. MACHOLD. No, I don't. I think it's an excellent idea. I've always been under the impression that some of that information was available because of what I read about the insider trading cases where in effect they have managed to look trade-by-trade at certain individuals.

Mr. KIRBY. They can find out that information, but it is at great effort. It's not easily available.

The CHAIRMAN. Well, gentlemen, thank you very, very much. Your testimony has been most helpful to us.

Now we have a panel of Robert Kanter, Managing Partner of ARBCO Limited Partnership; Victor Sperandeo, Managing General Partner of Hugo Securities; and Steven Wunsch, Vice President of Kidder Peabody and Company of New York.

Gentlemen, we're happy to have you present. We will proceed alphabetically starting with Mr. Kanter.

STATEMENT OF ROBERT A. KANTER, MANAGING PARTNER, ARBCO LIMITED PARTNERSHIP, NEW YORK, NY

Mr. KANTER. Mr. Chairman, my name is Robert Kanter. I'm the Managing Partner of ARBCO Limited Partnership, a New York based trading firm which I founded in 1979.

I have over 29 years of professional trading experience.

The CHAIRMAN. I should say at the beginning, gentlemen,—I don't think it's necessary in your case, Mr. Kanter, because you have a very concise statement—if you would confine your remarks to ten minutes or less we would sure appreciate it.

Mr. KANTER. I've had over 29 years of professional trading experience, including 15 years as a specialist on the American Stock Exchange.

I am pleased to have the opportunity to offer my personal experience and opinions on the practice of frontrunning. I respectfully refer the Committee to my written submission which briefly reviews the historical development of frontrunning, some examples of how this practice is implemented, and the steps which I believe are necessary to eliminate it.

Prior to expressing my feelings on frontrunning, I would like to take a minute to focus on the present state of potential stock market regulation. The various suggestions by some interested parties, in my opinion, are camouflaging the real issues.

An example is the focus on coordinating trading halts. First of all, it is questionable whether trading halts of any kind are beneficial. Second, they are akin to deciding after an individual who has been run over by a drunken driver and is dying in the hospital whether to pull the plug or not and at what time. The culprit is the drunken driver. The stock market is sick and the culprit is stock index futures. Either make sure the drunken driver does not drink or take away his license.

I would now like to use this time to make a few simple but important points about frontrunning.

The only difference between trading with material nonpublic market information as opposed to corporate information is the degree of profit and frequency thereof. Takeovers are infrequent with large profits. Trading with market information occurs continuously with extraordinarily high volume of smaller profits.

For everyone who frontruns, there is someone frontrun. That is, there is an innocent victim taking the other side of the frontrunner's trade.

Material market information can only be used improperly for profit if other parties are not in possession of such information.

Many member firm traders no longer provide depth and liquidity to the market in the proper manner. Instead, frontrunning activities have become a central focus of their trading operations.

Prior to the October 19, 1987 crash, there were few who realized they were being frontrun.

With this in mind, I believe that, without proper frontrunning legislation, the individual investor and other market participants who now know they are being frontrun will withdraw from the markets at an accelerated rate.

The present day firm trader who may only know how to make money frontrunning will become extinct if there is no one left to take the other side of the transactions.

As a consequence, our markets will lose a substantial amount of depth and liquidity and our capital formation process will be seriously impeded.

Inside market information is the lifeblood of the frontrunner. Large customers of member firms exchange material market and order flow information on a continuous basis throughout the trading day. This is accomplished through a network of firm traders and institutional salesmen using the member firm's internal squawk box and other means to communicate material market information by telephone to the firm's customers.

The small investor and other market participants who are unable to provide significant order flow and/or commission business to a member firm are excluded from participating in this information exchange. Therefore, they are forced to make pricing decisions without such information. As a result, they inevitably wind up taking the other side of the frontrunner's trades. The net result is an additional cost of doing business for the small investor, the extent of which, in my judgment, could be untold billions of dollars

in excess of the actual commission or transaction costs. When transaction costs such as these are hidden, an investor will enter into trades that never should have been initiated, resulting in a complete misallocation of resources.

The following corrective steps must be implemented as soon as possible:

(1) The federal securities and commodities laws must be amended to prohibit the practice of frontrunning. For example, the Insider Trading Proscriptions Act of 1987 should be passed in a form that will encompass intermarket frontrunning.

(2) The securities and futures exchanges should be required to adopt specific rules prohibiting intermarket and intramarket frontrunning. I must strongly emphasize at this time that frontrunning rules not be restricted to trading only immediately prior to knowledge of the execution of the order or basket but must be broad enough to include any trading at any time which takes advantage of the possession of material nonpublic information.

(3) Effective intermarket order trails must be implemented which identify all parties of each trade and computer programs developed to flag potential abusers.

(4) The anti-manipulation rules must be updated to encompass patterns of dealing in securities which, when reviewed in conjunction with patterns of dealing in futures and other derivative instruments, evidences an attempt to manipulate prices.

(5) Steps must be taken to increase the flow of institutional orders to the New York Stock Exchange floor by expanding the use of the DOT system in conjunction with the distribution of material market information to all market participants.

(6) The creation of a committee to study the feasibility of an electronic stock market to fulfill the congressional mandate as established in the Exchange Act of 1975 for the development of a national market system which provides equal access to market information to all participants.

(7) The committee should also study the feasibility of a complete separation of the agency and principal functions of broker-dealers.

In conclusion, circuit breakers, harmonious margins, and other band-aid fixes may or may not help our market in the short run. In the long run, however, only markets with integrity, which provide an equal access to information to all market participants and where talent and hard work encourage investor participation, will allow the U.S. financial markets to prosper.

Frontrunning is the antithesis of the above. It is a menace that must be stopped immediately. Thank you.

[The complete prepared statement of Mr. Kanter follows:]

STATEMENT OF ROBERT A. KANTER
MANAGING PARTNER OF ARBCO LIMITED PARTNERSHIP

I am the managing general partner of ARBCO, a New York-based trading firm which I founded in 1979. I have over twenty-nine years of professional trading experience, including fifteen years as a specialist on the American Stock Exchange.

I am pleased to have the opportunity to offer my personal experience and views on the practice of front-running. I would like to review briefly the historical development of front-running and then provide the Committee with a number of examples of how this practice is actually implemented. Finally, I would like to express my views on the steps which I believe are necessary to eliminate this abusive practice.

Front-running can be defined as conduct that involves trading while in possession of material non-public information concerning orders or transactions that affect or could affect the market price of the instrument purchased or sold. As a professional trader, it is my belief that individual investors and other market participants are continuously entering into transactions with parties who possess material non-public market information, the result being a transfer of untold sums of dollars from one group to the other. Eventually, if not stopped, public confidence in our markets will erode and the individual investor will be forced out of the market. In addition, professional traders and on-floor market-makers, who have been

taking the "other side" of the front-runners' trades, eventually will be unable to compete and will exit the market. Unless a series of corrective measures are implemented to provide a level playing field for all market participants, this abusive trading practice will ultimately destroy the liquidity, depth and integrity of our markets which, in turn, will adversely impact the capital formation process, our national economy, and U.S. global competitiveness.

In order to understand more fully the practice of front-running, a historical review is necessary to highlight the structural changes which have occurred in the financial markets, thereby setting the stage for the new forms of front-running which have recently emerged. The major U.S. stock exchanges have traditionally operated pursuant to an auction market system, that is, the highest price a market participant is willing to pay to purchase a security becomes the "best bid," and the lowest price a market participant is willing to sell a security becomes the "best offer." All parties express their intentions in a centralized market-place (an "exchange") where a specialist provides the service of facilitating and maintaining an orderly market. When a buyer and seller are willing to contract at the same price, a sale takes place with public dissemination of the transaction on vending machines and the broad tape. In addition, the specialist maintains the public orders in both price and time sequence, and has the responsibility of injecting himself as a

principal whenever there exists a temporary disparity in supply and demand. This system has always provided the small investor with equal trading opportunities. Price discovery was simple and fair, and the great majority of transactions took place among public investors with the specialist acting as agent. This system avoids the "markup" cost to the public inherent in dealer markets where the dealer could simultaneously buy from one customer and sell to another at a profit.

Prior to the abolition of fixed commission rates in 1975, member firms produced operating profits primarily from commission revenue, and did not particularly desire to assume principal risk. However, with the ever increasing institutionalization of the markets, some firms registered as block positioners were forced by their larger customers to buy or sell, as principal, blocks of stocks in conjunction with the specialist because the increased size of the orders required additional risk capital. The system worked relatively well -- the specialist received the necessary assistance, and the block firms used their agency income to mark down the costs of their risk position. It should be noted that, unlike the specialist, these block firms were allowed to act as agent and principal at the same time with a particular order. However, this arrangement creates an inherent conflict of interest between their interest as agent to obtain the "best" price for their customers and their interest as principal to obtain the best price for themselves.

With the abolition of fixed commission rates in 1975, competitive forces reduced institutional rates. Additional volume (which to a large extent was a result of lower commissions) and new products (exchange-traded options) more than offset actual commission rate reductions to member firms. However, with the introduction of the listed equity option, the concept of "intermarket front-running" began. Although front-running or "tape-racing" a customer's order on the floor of the stock exchange had been a problem in the past, the introduction of exchange-traded options presented an opportunity for certain firms to front-run a derivative of the security, without actually front-running the stock itself. Some member firms would effect trades in the options of those stocks which they assessed would have significant short-term price moves resulting from the buy or sell orders evidenced by their customer order flow. In addition, if a member firm, acting in the capacity of a block positioner, contracted with a customer to act as a principal and buy or sell a security at a discount or premium from the last publicly disseminated sale, the option transaction might be effected prior to public dissemination on the tape of the discounted or premium transaction, thereby effecting a hedge at a preferred price. The preferred price resulted from the fact that the "other side" of the option transaction based its pricing without the knowledge of the contracted but not printed transaction.

Sophisticated front-running operations were established, whereby communication links were effected between certain stocks on the New York Stock Exchange and their corresponding options at the Chicago Board Options Exchange. The practice worked as follows: A member of the New York Stock Exchange would stand next to the specialist. The lag time between actual sale and its evidence on the high speed ticker could be anywhere from fifteen seconds to three minutes. If there was a disparity between the last recorded transaction and the next consummated sale, the member would notify his clerk of the price of the last sale via a hand signal. The clerk would then instantaneously telephone a clerk on the floor of the Chicago Board Options Exchange who would hand signal the information to his broker in the corresponding option class, who would, in turn, effect a transaction in the option prior to the publicly disseminated sale on the high speed ticker. It should be pointed out that during this period - from 1975 to 1976 - the front-runners claimed they were merely keeping the two markets in line, the same defense now being voiced by the index arbitraguers. However, an uproar developed in 1976 on the part of those Chicago Board Options Exchange market-makers who were taking the other side of the front-runners' transactions. The exchanges eventually adopted policies prohibiting this practice as inconsistent with just and equitable principals of trade. However, the exchanges' actions were limited to intermarket front-running activities in securities transactions.

With the introduction of stock index futures in the early 1980's and the 1982 amendments to the Commodity Exchange Act and the federal securities laws, which effectively bifurcated regulatory authority over stock index products between the SEC and the CFTC, the stage was set for intermarket front-running using securities and futures. Since there were no specific exchange rules prohibiting this type of intermarket front-running, the use of CFTC regulated futures contracts insulated the front-runner from the existing rules or policies of the securities exchanges. In addition, the increased institutionalization of the market led to the negotiation and consummation of block trades with upstairs broker-dealers rather than on the floor of any stock exchange. Furthermore, the investment of billions of dollars in so-called "index funds," which replicated the major stock indexes, and the proliferation of exchange - traded stock index products led to the development of a market for "baskets" of stocks as substitutions for an entire index. Thus, a member firm could trade a basket of stocks and use stock index products to hedge their risk prior to the execution and public dissemination of the basket order. When institutions received basket bids and/or offers from member firms, the member firms would frequently guarantee the trade at the closing market price. This allowed the member firm to position itself throughout the day. Profit sharing agreements between the firms and their customers, representing the front-

running advantage given by the customer to the firm in possession of this material market information, became common. Commissions were further slashed and at times even eliminated by the member firms so that they could routinely capture order flow and rights of first refusal to participate in the basket trade.

A typical front-running transaction might occur as follows: An individual investor or other market participant may be offering to sell 1000 shares of XYZ at 30 and will place his order on the specialist's book at the New York Stock Exchange. The last sale price of XYZ was 29-3/4. The customer desiring to sell has no knowledge that a member firm, as part of a basket trade (a "buy program"), has already committed to sell 160,000 shares of XYZ to a large pension fund customer at the day's last sale price. It is reasonable to assume that the member firm would sell the stock at a premium. The member firm might buy 1000 shares of XYZ from the individual investor at 30 and resell it to the pension fund at the end of the day at 31. Or if, in fact, the member firm chose to hedge with index futures, it might purchase futures from an individual or market participant at a "preferred" price in that the seller of the futures contract, in his pricing decision, is unaware of the pending purchase order in XYZ and the other stocks comprising the basket order (or buy program). In other situations, the member firm might simply front-run a customer's basket order or buy program by taking a position in the corresponding stock index futures contract

immediately prior to the public dissemination of the basket order or buy program. In addition to the member firm using this information for its own trading advantage, this information may be exchanged between the firm's customers. Salesmen, with the aid of the "squawk box," continuously exchange market information over the telephone. But the individual investor is too small to get order flow information from member firms. This information is reserved for institutions and other exceptionally large customers that provide the member firm with large commission revenues and/or order flow due to the volume of their trading activities. The result is that one group with information is taking money from the group which does not have access to such information. There is thus a hidden commission or front-running cost to the general public. Although there are no empirical studies, the cost, in my judgment, involves billions of dollars.

The potential profits which can be gained by the practitioners of this practice are obvious, but there are also tremendous economic costs. The true tragedy is that these costs are hidden. When the costs are hidden, one will enter into transactions that never should have been initiated, resulting in a complete misallocation of resources. Finally, this practice enhances inter-day volatility. Rushing into the futures markets with large orders separates the spread between the cash and futures markets allowing arbitrage programs to enter the market. Later in the day, as profitable futures positions are closed, the

spread separates again. This volatility results in wide daily variations in stock and index prices. As the individual investor continues to find that he has bought at the daily high and sold at the daily low, investor confidence will be only further eroded. The markets should be freed of this inequitable and parasitical practice in order to permit those participants with intelligence and foresight to prosper in an open and competitive market, instead of being constantly defrauded by an "order oligopoly."

I recommend that the following actions be undertaken:

1. The federal securities and commodity futures laws must be amended to prohibit the practice of intermarket front-running. For example, the Insider Trading Proscriptions Act of 1987 should be passed. However, the bill must be broadened to cover the purchase or sale of futures contracts based on material non-public information instead of only securities. It must be made clear in the legislation that material non-public information includes non-public order flow information.

2. The securities and futures exchanges should be required to adopt specific rules prohibiting inter-market and intra-market front-running. Although front-running is currently prohibited by the securities and futures exchanges as a violation of just and equitable principles of trade, this prohibition is not strong or

specific enough. Existing rules which prohibit trading on the basis of knowledge of the material terms of an order that has been contracted but not yet publicly disseminated should be broadened to encompass material market information which, if known to the other side, would alter its trading decision.

3. Effective inter-market audit trails must be implemented. Information should include time of trade and identification of all parties to the trade. This can be accomplished by the clearing houses and member firms as part of the clearing process. Computer programs should be developed to "flag" potential abuses.

4. The anti-manipulation rules must be updated to encompass patterns of dealing in securities which, when viewed in conjunction with patterns of dealing in derivative futures and options products, evidences an attempt to manipulate market prices.

5. Steps to increase the flow of institutional orders to the New York Stock Exchange floor by expanding the use of the DOT system should be implemented. Consistent with the precedent of distributing relevant market information prior to the expiration of stock index futures contracts (the "triple witching hour"), the New York Stock Exchange should expand these activities to provide a mechanism to distribute relevant order flow information

to all participants to thwart the current "private club" of information suppliers.

6. The creation of a committee to study the feasibility of an electronic stock market to fulfill the Congressional mandate, as established in the Exchange Act of 1975, for the development of a national market system which provides equal access to market information to all participants. The Committee should also study the feasibility of a complete separation of the agency and principal functions of broker-dealers.

The CHAIRMAN. Thank you very much, Mr. Kanter.
Mr. Sperandeo.

STATEMENT OF VICTOR SPERANDEO, GENERAL PARTNER OF HUGO SECURITIES CO.

Mr. SPERANDEO. Thank you for having me here, Senator.

I'm the Managing General Partner of Hugo Securities. It's a New York based trading firm. I've got a total of 22 years of trading experience. I've been trading options since 1968, futures since 1967. I don't handle client accounts. I'm a professional. So I just deal for myself on a much smaller scale than the numbers being tossed around here.

But presently ruled pertaining to frontrunning and manipulation and program trading, etc., are unclear and the honest market participant is compromised and disadvantaged by his interpretation of what is proper compared to other parties who interpret such rules and exploit them in different ways.

Since in my opinion capital markets are presently regulated by whim rather than rule, my purpose is to clearly define that which is unclear and press for the development of a set of rules which everyone can understand. Now bear in mind that I'm a laissez-faire capitalist. I understand we have regulated markets. I'm trying to define and understand the current rules pertaining to regulated markets.

I'd like to just define a couple of terms as the way I see things. Frontrunning can be defined as a conduct that involves trading while in the possession nonpublic information concerning orders or transactions that affect or could affect the market price of the instrument purchased or sold.

Now manipulation, which Webster defines—that's a personal interpretation, Senator. This definition of manipulation comes right out of Webster's Collegiate Dictionary—"To treat or operate with the hands or by mechanical means especially with skill; to manage or utilize skillfully: To control or play upon by artful, unfair or insidious means especially to one's own advantage; to change by artful or unfair means so as to serve one's purpose."

Now a fair practice that's understood in Wall Street is arbitrage, and I just want to quickly differentiate manipulate and arbitrage. Now arbitrage is the purchase and the simultaneous sale of the same or equivalent security in order to profit from price discrepancies. Now program trading involves many different strategies utilizing futures, options, stocks and occasionally bonds. Besides the common program trading of simultaneously buying a basket of stocks and selling futures to effect a rate of return slightly greater than the yield on Treasury bills, the frontrunning program effected under the guise of arbitrage, is not executed simultaneously and is done skillfully by artful and unfair means to serve one's purpose. This activity should be illegal.

In other words, when people talk about program trading in a beneficent way, they use this example of buying stock and selling futures at a slight premium. The differentiation between that practice, which is not at all benevolent, is that it's done simultaneously. I think this is a real key in understanding the difference between

frontrunning and program trading. One is done simultaneously; one is not done simultaneously; and I'll get to an example in just one second.

The following example expresses an illegal program. A program trader might buy options on a basket of stocks such as the S&P 100, commonly called the OEX. After buying call options in great size, he later (not simultaneously) buys the stocks in incremental steps, moving the market up in value. Before the close of trading he sells futures to hedge the stocks he previously bought. Since the futures sold become a hedge against the stock he has purchased which has driven the market up, he then utilizes his cash-out privileges in the options market and exchanges or exercises his options for cash. This is done after the close so he literally buys something, moves it up, and then it's literally sold because it's exercised for cash not something else, which is usually the way security options are exercised. When you exercise a security option, like an IBM, you get IBM. In these cash options, you get cash. So you literally can buy something up at the high for the day and then you get your money for it. It's a big difference in what used to be before the OEX and the XMI were developed—these index options.

Another form of manipulation would be in this current position this man is now left with stock and he's sold futures against them is to sell the stock the next day badly and buy back the futures on the way down. So he's moving the market down at the same time—he wants the market to go down a lot because he still has his futures which are making money on the downside whereas he's unloading the stock he bought the day before to move the market up.

In my opinion, these manipulations and others could be prevented by implementing a simple rule. This is possibly in answer to the question you've asked before. Either all buys and sells are done simultaneously, or, if not, a 24-hour period must ensue before the opposite side of the trade can be executed. To define that just a little bit more clearly, if one buys stock and sells futures simultaneously, fine. That's an arbitrage. If one buys stock and is buying stock all day and decides to sell futures near the end of the day, he's really doing two trades but they're not together. So if he wants to buy stock and sell futures simultaneously, he should wait 24 hours. I get that from a rule that was inputted into the New York Stock Exchange in the late 1960's or early 1970's where as principal upstairs traders, if we bought stock on upticks, meaning we were following the market up, we had to wait 24 hours to resell that stock. If we bought stock on downticks, we could sell it at any time. Obviously stabilizing the market would be buying on a downtick and that was what the New York Stock Exchange wanted to enhance traders to think about doing.

If these practices and others such as these continue, illiquidity and greater volatility will persist and the honest market participants will be unable to compete and be driven from the marketplace.

Now if I may, may I give you a table here just as my final thing rather than reading a table? Is there a way I can get you this?

The CHAIRMAN. Yes. It will be printed in full in the record. We have a copy of it here.

Mr. SPERANDEO. Good. If you look at this table, I think this is somewhat documentation—and I don't like to relate to October 19th as the point in case because that's one example that's not likely to happen too many times. I want to run down—this is a table that is recording all moves in the marketplace that lasts from weeks to months, and you can see that the previous—I put the caption of what I identified and this is a subjective judgment next to what caused these great catastrophes. Now you can see that, for instance, most of these large drops in history over a period of weeks occurred in the depression and the San Francisco earthquake that caused a large drop in the market of 37.6 percent, and then there was World War II, the Nixon tapes obviously hurt the market when that was coming out. There's one that I didn't put in that I think really strikes the case here because obviously, as of right now, there's no identifiable catastrophe that you could associate the October 2nd to October 19th selloff which was the 12th largest in history and is 34.2 percent.

Now the largest short-term drop in a period of days, 8 days, was when Hitler invaded Dunkirk. The market dropped 22 percent in 8 days. We did that in literally 1 day on October 19th. Now if you can associate all these major catastrophes in history with these large percentage drops, obviously program trading, portfolio insurance certainly enhanced the decline that took place on October 19th.

Thank you, sir.

[The complete prepared statement of Mr. Sperandeo follows:]

STATEMENT BY VICTOR SPERANDEO

General Partner of Hugo Securities Company

I am the managing general partner of Hugo Securities Company, a New York based trading firm, which I founded in 1979. I have been trading options since 1968 and futures since 1976.

I am a laissez-faire capitalist and I stand for free markets. As long as we have regulated markets, I only ask that the rules be clearly stated.

Presently, rules pertaining to front running, manipulation and program trading are unclear and the honest market participant is compromised and disadvantaged by his interpretation of what is proper compared to other parties who interpret such rules and exploit them in different ways. Since, in my opinion, the capital markets are presently regulated by whim rather than rule, my purpose is to clearly define that which is unclear and press for the development of a set or rules which everyone can understand.

Front-running can be defined as conduct that involves trading while in possession of material non-public information concerning orders or transactions that affect or could affect the market price of the instrument purchased or sold.

Manipulation, Webster defines as follows: "1. To treat or operate with the hands or by mechanical means especially with skill; 2. To manage or utilize skillfully: To control or play upon by artful, unfair or insidious means especially to one's own advantage; 3. To change by artful or unfair means so as to serve one's purpose. "

The same dictionary defines arbitrage as "A simultaneous

purchase and sale of the same or equivalent security in order to profit from price discrepancies."

Program trading involves many different strategies, utilizing futures, options, stocks and occasionally bonds. Besides the common program trade of simultaneously buying a basket of stocks and selling futures to effect the rate of return slightly greater than the yield on treasury bills, the front-running program affected under the guise of arbitrage is not executed simultaneously and is done skillfully by artful and unfair means to serve one's purpose. This activity should be made illegal.

The following example expresses an illegal program. A program trader might buy options on a basket of stocks such as the S&P 100 (commonly called the OEX). After buying call options, he later (not simultaneously) buys the stocks in incremental steps, moving the market up in value. Before the close of trading he sells futures to hedge the stocks he previously bought. Since the futures sold become a hedge against the stock he has purchased, which has driven the market up, he then utilizes his cash-out privileges in the options and exchanges or exercises his options for cash. He is left with a hedged position and has manipulated the market by driving it higher to affect cashing-out of the options at the highest possible price (the closing index price).

Another form of manipulation involving front-running would be when a market participant buys stocks and sells futures, then utilizes his market power to sell the stocks poorly, forcing the market down, eventually culminating in his repurchasing the futures at the bottom.

In my opinion these manipulations and others could be prevented by implementing a simple rule. Either all buys and sells must occur simultaneously or, if not, a 24-hour period must ensue before the opposite side of the trade can be executed.

If these practices and others such as these continue, illiquidity and greater volatiity will persist and the honest market participants will be unable to compete.

I welcome any questions, Mr. Chairman. Thank you.

TABLE I

Largest % Drops in History	Cycle Year	Primary Leg #	# of Days	Type of Market	Rank	Total Bear Market % Drop	Underlying Circumstances
34.2	1987-	2	17	Bear	?	?	
34.4	1972-74	4	205	Bear	3rd Worst	- 47.1%	Nixon, OPEC, Fed
35.7	1929-32	4	97	Bear	Worst	- 91.1%	Depression
36.3	1912-14	4	467	Bear	8th Worst	- 36.6%	WWI
37.3	1932-36	1*	173	Bull	After a rise of 93.4%		
37.4	1929-32	5	98	Bear	Worst	- 91.1%	Depression
37.6	1906-07	4	196	Bear	5th Worst	- 44.9%	San Fran. Earthqus aftermath
39.0	1929-32	7	37	Bear	Worst	- 91.1%	Depression
40.2	1936-37	2	102	Bear	2nd Worst	- 49.8%	Depression
43.7	1929-32	2	34	Bear	Worst	- 91.1%	Depression
44.8	1929-32	6	100	Bear	Worst	- 91.1%	Depression
53.6	1929-32	8	122	Bear	Worst	- 91.1%	Depression

NOTE: The October 2-19, 1987 drop, which in technical terms is called a primary leg, was the 12th largest percentage drop over a period of weeks in 93 years. Since the eleven others have all been associated with catastrophies, and since no known catastrophies have been associated with the October crash, it is fair to conclude that program trading contributed a great deal to this drop.

*This drop was a correction of the 1932 bear market bottom. The rally was 93.4% and the correction was a 37% drop.

The CHAIRMAN. Thank you very much, Mr. Sperandeo.
Mr. Wunsch.

STATEMENT OF R. STEVEN WUNSCH, VICE PRESIDENT, KIDDER, PEABODY & COMPANY, NEW YORK, NY

Mr. WUNSCH. Thank you, Mr. Chairman, for this opportunity to express my views on frontrunning.

[The complete prepared statement of Mr. Wunsch follows:]

HEARINGS ON MARKET MECHANISMS
TESTIMONY REGARDING FRONTRUNNING

April 20, 1988

By

R. STEVEN WUNSCH
VICE PRESIDENT
KIDDER, PEABODY & COMPANY

Thank you, Mr. Chairman, for this opportunity to express my views on frontrunning. It may seem on first glance that frontrunning is as easy to define as it is unethical. Unfortunately, simple definitions could lead to ineffective regulation, while distracting attention from important structural changes that would eliminate the problem without regulation. Today I would like to make 3 points:

1) Frontrunning is nearly impossible to adequately define for regulatory purposes, because prohibited activities can easily be replaced by equivalent activities falling outside of any particular definition.

2) Expanding the definition of illegal frontrunning could have the unintended consequence of reducing market liquidity.

3) Effective solutions to the problem require a coordinated regulatory effort to encourage the development of automated order match facilities for all related markets, which would naturally protect customers against frontrunning.

A simple definition of frontrunning, such as, *trading ahead of a customer's order in the broker's house account*, certainly describes an unethical practice, which should be prohibited in each market, as it is now, and across markets, which will require coordinated regulatory efforts. Even if all versions of frontrunning by the above definition could be stopped, however, many other activities equally profitable to the broker and equally damaging to the customer could substitute for the prohibited activity. For example, the broker could impact the market with the customer's trade while simultaneously taking an opposite position to profit from the bounce back from the impact, a sort of "backrunning" strategy. Or the broker could subtly and undetectably pass along information about the trade to another party who could either backrun or frontrun it and pay the broker back with either commissions or similar information of equal value. Since it would be impossible to catalog all of the ways in which confidential information about a customer's trading intentions could be abused, and since all of them are interchangable, stopping frontrunning with regulation is like trying to squeeze the air out of a closed balloon -- it will pop up wherever you're not squeezing.

In spite of these difficulties, coordinated and sophisticated regulatory guidance in this area is very beneficial, because it points the way to the appropriate relationship between broker and customer. A regulatory environment characterized by concern that brokers might abuse confidential customer trading information will strongly motivate brokers to adopt effective internal safeguards for competitive reasons, such as separating agency activities from dealer activities.

It is fortunate that effective control of abuses can be accomplished without expanding the definition of frontrunning, because expansion runs the risk of inhibiting marketmaking, the primary source of liquidity in today's markets. The essence of marketmaking is pre-positioning -- buying ahead of buyers and selling ahead of sellers. Overly inclusive definitions of frontrunning could cause marketmakers to believe that their activities are also prohibited, which would curtail their ability to provide liquidity.

Futures market liquidity is inhibited now, for example, by rules designed to prevent frontrunning. These rules prohibit off-floor discussion of impending trades, making such common stock market practices as pre-arranged block trading or advertising to find the other side of a trade illegal in futures markets. This regulatory conflict is as confusing as it is counterproductive. Not only are customers prevented, in the name of customer protection, from engaging in trading strategies that would benefit them, but there is reason to believe that October 19th would have been easier for marketmakers to handle had these rules not inhibited the flow of accurate information about participants' trading requirements.

Nothing would improve the functioning of our markets more than facilities designed to allow, encourage and, in some instances, require the equal distribution of accurate order flow information to all participants. Electronic information distribution is the most important feature of automated order match systems. Unfortunately, exchanges, whose marketmakers now have a monopoly on such information, have successfully opposed automated systems through such rules as the above mentioned futures market rules and stock market rules keeping the

specialist's order book secret. Electronic distribution of such information is a goal fully consistent with the Securities Act Amendment of 1975, in which Congress directed the SEC to facilitate the development of a National Market System for securities. In the United States, automated order match systems scarcely exist for securities and have hardly even been contemplated for commodities. But other markets, most notably the Tokyo Stock Exchange and the Toronto Stock Exchange, have developed such systems, both for securities and commodities, which could result in the loss of U. S. transaction business to foreign market centers.

Importantly with respect to the issue at hand today, automated order match systems would provide the most complete answer to the frontrunning problem. It would be nearly impossible, for example, to frontrun the computerized single price open or close of the Japanese market, because everyone has equal information and trades at the same time and price. And the computerized continuous market between the open and close in Japan enables the strict enforcement of time as well as price priority in order execution, which is certainly an important safeguard against frontrunning, which we do not have.

A primary goal of intermarket regulatory coodination should be to develop automated order match facilities for securities and related commodities that are consistent with each other and effective. The first item on the agenda of any coordinating group with such responsibilities should be a thorough examination of trading systems available now around the world. The U. S. could very well be falling behind, because our competing securities and commodities systems are spending more energy defending their old ways against each other than on developing new approaches together to better compete with rapidly growing market centers abroad.

R. Steven Wunsch (212) 510-5221

The CHAIRMAN. Thank you very much, Mr. Wunsch.

Mr. Wunsch, how about answering the question I asked the preceding two witnesses: why not simply stop brokers from trading for their own account, period? You tell us that if everybody has the same information there's no problem. It seems to me there can be a very big problem unless you're going to give information out in advance on a purchase, for instance, of a large block of stock by a customer. Say the New Jersey pension fund comes in with a purchase of tens of millions of dollars of stock in a particular corporation. Would that have to be disclosed to everybody before the execution of the order? That's not a very practical solution, is it?

Mr. WUNSCH. I have argued that it is a very practical solution from the client's perspective to disclose as widely as possible.

The CHAIRMAN. After he makes the purchase, sure. Before he makes the purchase, somebody slips in ahead of him and when he buys the stock the price is higher. Isn't that right?

Mr. WUNSCH. If the entire world is trying to frontrun him,—if you think about how frontrunning works, it requires buying ahead of the client or passing along the information to someone who buys ahead of the client, which then gives the person who did that an incentive to push the price up and then sell when the client comes in to buy.

Now if the entire world has done that, that means that the entire world would have bought ahead of the client and then be trying to sell when the client sells. Now if everyone is trying to sell when I'm trying to buy, I think that's a good situation for me.

To more particularly answer the question you asked——

The CHAIRMAN. Well, let me pursue it in a little different way. We don't allow jockeys to bet not only on the race they're in but they're not allowed to bet on the races, period, and we don't allow NFL quarterbacks to bet on the outcome of a game that they're in. They've done that in the past and been kicked out of football. They obviously are in a position to influence the outcome.

In the same way, it seems to me it's not very difficult to understand how clear and ethical decision it would be if you simply said you're a broker, you make a fine business as a broker, but you shouldn't be trading for your own account. What's wrong with that?

Mr. WUNSCH. I personally think that's a good idea and brokers, as we have at our firm, should for competitive reasons try to make separations like that. In other words, in program trading, we at our firm have separated our house activities from our customer activities by a considerable distance in many respects. So that our customers who come to our customer program trading operation know that there are no house incentives to profit off their trading information. I think it's a very good idea for brokers to do that themselves.

I don't think it's a bad idea particularly for regulators to somehow formulate either rules or guidelines to try and direct brokers in that way.

The CHAIRMAN. Do most brokers today have internal rules covering these practices now?

Mr. WUNSCH. I believe that most brokers do not, but I think that some do and we do, and I believe that more will in the future as the number of——

The CHAIRMAN. Let me ask you what internal safeguards exist at your firm to control frontrunning?

Mr. WUNSCH. At the operation that I work in, which is the financial futures department where we conduct customer index and arbitrage activities, we have no house accounts being traded in that entire building—or in that entire floor where that operation exists. All of our proprietary accounts are conducted a couple of blocks away in a different place.

The CHAIRMAN. Are you satisfied that that's effective?

Mr. WUNSCH. I'm satisfied that's very effective.

The CHAIRMAN. Well, you say that some do and some don't and I get the impression that most do not have that kind of rigorous protection. Why shouldn't we by regulation require it?

Mr. WUNSCH. Again, I don't think it's such a bad idea to try and guide brokers in that direction. However, I think unless the broker really wants to do it for customer protection reasons, it would be easy enough to evade any rules that were actually put in place.

The CHAIRMAN. Well, you could prosecute him. You could make it a criminal offense to engage in that kind of activity. Why wouldn't that be effective?

Mr. WUNSCH. For the same reason that prosecuting frontrunning now is not all that effective in stopping the practice.

The CHAIRMAN. The most effective factor would be the aura of integrity that would attract the customer.

Have any of your brokerage clients ever asked about your firm's policy on frontrunning?

Mr. WUNSCH. Oh, yes.

The CHAIRMAN. They have?

PROGRAM TRADING

Mr. WUNSCH. Yes. Many of our clients are concerned about program trading and frontrunning and particularly program trading in the context of frontrunning and perhaps the other way around as well, and we have endeavored since we began such activities for customers to separate our house activities from our customer activities and many customers have expressed I guess relief would be the best term for that for the way we have structured our facilities.

The CHAIRMAN. Mr. Sperandeo, you have described one type of scheme in your testimony. Could you take a minute to describe an alternative or other methods?

Mr. SPERANDEO. All right. This is like, if I could use a metaphor, airplanes make all seats the same size. It's the people that are different that fit into the seats. Program trading, as the term implies, is really a variety of different creative strategies that very bright people who are in this business conceive of to make money. I use the example of the tax accountant that devised the scheme to write off Arabian horses. It's kind of weird when you think about Arabian horses being a tax deduction.

In this case, money is really so vast and so massive that I could give you a half a dozen to a dozen different practices that I have

observed to be taking place. I wouldn't necessarily cover them all. Some of these are very complex, Senator. I'll give you another brief one perhaps which I'll try not to make too complex.

Let's say somebody wanted to force the market down and most of these things occur if you did a study you would see in the last half hour to the last hour of trading. There's no news coming out. I mean people pick their spots here. This is not like it's done before the GNP report is put out. They really take maybe a quiet day, Veterans Day or something where banks are closed, and they will pick a time at, say three o'clock. They will have now crossed some stock with a customer on the Pacific Coast and taken a big position in stocks on the long side, which really is going to be sold, and they then buy a lot of puts before they sell it, sell a lot of futures in larger quantities in amounts, meaning the amount of money involved, and then proceed to sell the stock down on downticks, which is now long stocks since they bought it on the Pacific Coast, and then at the end of the day cash in their options, cover their futures, since they know how much stock they have to sell.

See, there's a big difference. People know how much they have and you, as a market observer, don't know. It's kind of like dealing cards to you and they know what the cards are, so they know when you have a good hand and if you do they drop out. If they know you have a bad hand, they naturally press their bets. But the point is, at the close they cash out their futures, cash out their options, and then sell the stock back to the client that they bought the stock from so they in effect could sell it long, if you know what I mean by long and short here. I'm assuming you do. But they press the market down because they've taken advantage of a rule and a few sophisticated strategies.

The CHAIRMAN. And how would you deal with that?

Mr. SPERANDEO. You have to make a rule if you want to curb any and all of these practices that unless you do something simultaneously—in other words, if you buy something and sell a future or buy stock and sell an option, it's not done simultaneously, then you have to wait 24 hours—and I'm picking that out of the hat because of the 24-hour rule as I related here earlier here in the late 1960's—before you can do the other side. Then you can move the markets around a little. Then there would be really a lot of risk. There's no risk between doing something for an hour or half an hour if you're dealing in $100 million to $500 million, which is by the way the numbers that go on in those last hours. It's not on expiration day of these options either. I mean this is a pretty common practice. If you did any investigations on this, you would see that a lot of money is changing hands between 3 and 4 when the market closes.

The CHAIRMAN. Mr. Kanter, you differentiate between trading only immediately prior to knowledge of the execution of the order or basket from trading with possession of material and nonpublic information. Can you explain that?

STOPPING EXCHANGE OF INFORMATION

Mr. KANTER. The key to stopping frontrunning, in my judgment, is not specifically stopping the perpetrator from selling or buying a

future immediately prior to knowledge that a basket trade or a large amount of stock is going to print. This is simple. I don't think very many of the firms engage in this practice in an ongoing way and it's penny ante.

My judgment of the nuts and bolts of this issue is in effect stopping the private club of exchange of information between large market participants at the detriment of with the individual investor and other market participants. If in fact the member firm acts as a conduit between this exchange of information, which they do continuously under the sometimes appropriate and sometimes inappropriate guise of finding the other side of a customer's order, in effect this privileged group of large customers have information as to potential direction of markets or individual stocks that they can utilize for their own benefit much greater than they could before derivative instruments because of the advent of having futures and options as an alternative, not just easily frontrunning the security itself, as these two gentlemen in back of me referred to. Then the individual investor who's just sitting there as a dummy on the book of the New York Stock Exchange specialist becomes the one that gives the party.

Therefore, just stopping overt frontrunning is not particularly the answer. It is a smokescreen but it is not the answer.

Now there are self-regulatory exchanges that I think will be coming out with specific frontrunning rules. If in fact those rules are limited to frontrunning just prior to the execution or if in fact they are illegal only because of the knowledge of the execution itself, then those frontrunning rules are addressing the small part of the big picture.

PROHIBIT TRADING ON MATERIAL MARKET INFORMATION

The rules have to be specific and broad enough to in prohibit trading on material market information even though the execution might not be imminent because whether it be known and exploited by the member firm or known and exploited or utilized by the member firm customers. It is not known by the small investor who takes the other side of the transaction. If it weren't for the small investor who takes the other side of these transactions, it wouldn't be going on. There would be no one to give the party.

The CHAIRMAN. Currently I understand the New York Stock Exchange is considering an interpretation of its ethics policy that would address frontrunning.

Can you describe what you think the board should do to cut down on the problem?

Mr. KANTER. Well, I'm aware of a memorandum that's been sent out in the last week from the New York Stock Exchange asking for comment from its membership as to a proposed frontrunning rule that will be submitted to the SEC.

In reading the memorandum, it was somewhat confusing to me in that at certain spots it referred to the rule being in possession of material nonpublic information and in effect if in fact that possession may influence future stock or index prices trading on that would be illegal, and in a different interpretation of the same memorandum it seems quantified and qualified to the knowledge of

in fact the execution. Therefore, one in effect fits in a limited category which I think would be ineffective, and the other has a much broader perspective and therefore might be effective.

The CHAIRMAN. I have an information memo dated April 13. It may be the same thing you're referring to. It reads as follows. "Specifically, the Exchange is considering the adoption of an interpretation whereby trading in index futures immediately prior to and with knowledge of the execution of one or more baskets of stock, that favorably impact the value of the underlying index, could constitute frontrunning." That's to be a violation.

It goes on to say, "When a member is in possession of material nonpublic market information concerning one or more baskets of stock, the execution of which affects the value of an index, trading in futures on that index before information concerning the execution of this stock basket has been made publicly available to take advantage of the nonpublic information may violate just and equitable principles of trade."

It seems to me that it's simpler to say brokers can't trade in stock in their own account. They can trade for their customers, period.

Mr. KANTER. May I comment on that?

The CHAIRMAN. Yes, I wish you would.

Mr. KANTER. There's no question that that is the solution. With all due respect to you, Senator, it seems like something which is possibly impractical in today's world in that a large amount of the risk capital is being provided by those member firms. To exempt a Goldman Sachs or Salomon Brothers from utilizing that amount of risk capital could very well damage the marketplace and that that capital would not be available to promote depth of liquidity.

The CHAIRMAN. They can be an investment operation. There's nothing wrong with that. But to do both, it seems to me that if the preceding two witnesses were also brokers, they would develop a conflict of interest. They're doing very well as investors. That's their profession. That's their business. They're very skilled at it.

Now you're telling me that brokers should be allowed to do both, be investors and brokers. Is that right?

Mr. KANTER. No. I have here a 100-page report on the feasibility and advisability of the complete segregation of the functions of broker-dealer written for the president—I think at the time it was President Roosevelt in 1936. Now if you look at the tenor of the time——

The CHAIRMAN. Think of all the trouble we would have saved if we had enacted it 50 years ago.

Mr. KANTER. I have nothing else to say. But that certainly is the answer. If that can't be accomplished—and I wish it could be—then, besides the various suggestions I have made and the other gentlemen have made, certainly there should be strict——

The CHAIRMAN. You make a very, very good point when you point out that Goldman Sachs and other outstanding firms like that are very important as investors and it would I presume have a significant effect on the capital available to our capital markets after that was put into effect. Couldn't we have some kind of transition?

Mr. KANTER. Well, I think you are the expert in the world on, in effect, how the banks have mitigated their cross conflicts of interest and I think—correct me if I'm wrong—within your present Glass-Steagall legislation they might not be guaranteed subs, but they would be connected in a less formal way. Now why can't we do the same thing with the investment banks?

The CHAIRMAN. You see, we have what are I think very effective safeguards there. The regulators all think they're effective. They are enthusiastically for the legislation. We require that the underwriting be done in a separate affiliate, not a subsidiary, an affiliate. We say the bank can't loan to that affiliate. We say they can't buy what the affiliate is selling. So that we do separate it effectively.

Now if you apply that, that's not a bad idea. We could consider the possibility of recommending that.

Mr. KANTER. That would be a wonderful blueprint for the securities industry. It certainly would solve frontrunning.

The CHAIRMAN. All right. Let me ask Mr. Sperandeo about that.

BLOCK TRADERS

Mr. SPERANDEO. I disagree from this point of view. What the large member firms are doing—and as you pointed out before, they seem to be making more money from their own accounts than they are from commissions. Now there's a very simple reason why. Because if I was a block trader—I, by the way, at one time was for a firm called Weed and Company. I used to trade we called them glamour stocks in those days, IBM, etc.—and a client would call me up, say, Citibank, and say, "What would you bid for 50,000 IBM," I would bid a point under the market which would be very generous. The stock is now in my name. In other words, now I'm the principal. So Goldman Sachs and Salomon Brothers, to name the two biggest, they take this stock down in their own name. So if you said you can only trade for your own account or for customers, they would theoretically become a principal dealer so when you wanted to sell your billion dollar portfolio and go from stocks to bonds, which happens quite often, and they principal that trade, they are in effect trading in their own name because they buy that stock from the client in what they call a package. Some of these are packages and they have various names for them. And they take that package and now it's theirs. But before they sell the stock which they just bought, they go out and sell—and I'm exaggerating—$2 billion in futures and buy $2 billion in equivalent options or say puts. Then they sell their stock.

Now they've done everything in their own name. It's principal. You haven't solved the frontrunning problem. They've sold the billion dollars but they've made—and I'm exaggerating this a bit—because they've had amounts in equivalent securities, futures and options in this case to the extent of let's say $3 billion, as the market goes down they are making three times as much as they're losing by selling that stock. That's not the client's any more. They paid the client probably a very good price to get that stock to push the market down to make more by selling it badly because they're short three times in equivalence as to what they're long.

So if you said to brokers or if I were the chairman of Salomon Brothers and said, "Well, you can only trade for your own account, you can't do both," I'd say, "Well, we only do principal transactions." It wouldn't change anything.

The CHAIRMAN. Mr. Kanter.

Mr. KANTER. Well, my respected friend, if in fact I wanted to participate in a block of stock as an affiliate and I only could deal, as the Senator said, as an investor, then I would not be privileged or have the facility to be shown that block of stock because I am not an agent and in effect all principal traders would be on equal footing. The big advantage that the present firms have in acting as principal and agent simultaneously is in effect right of first refusal. You do not get that. I do not get that because we are not brokers who are getting calls from clients who want to buy or sell stock.

The CHAIRMAN. Mr. Wunsch, will you comment?

Mr. WUNSCH. I think the feasibility of separating broker-dealer from agency functions is the key issue. No one would argue—and we certainly wouldn't at our firm—that separating agency activities from dealer activities does not have merit from our clients' perspective.

However, if you look at who the market makers are and you recognize that market makers include everyone from floor locals in futures pits to specialists in the stock market to upstairs dealers to hedge funds and other call them more privileged clients of those dealers, it's clear that even if you made a rule that said the broker-dealer has to entirely separate his agency and dealer activities, that the broker-dealer could simply pass along the information that he would use in his own account if he were able to, if he wanted to do this, if he was unethically minded and going to do this—he could pass along the information that he ordinarily would have used in his own account, if you permitted it, to someone else who would use it in his account such as a hedge fund. Therefore, just making that rule of separation wouldn't necessarily solve the problem. In addition, it could create a host of other problems.

The CHAIRMAN. Then no affiliate or whatever should be allowed to trade because of the mobility of information. It's almost impossible to regulate that.

Mr. WUNSCH. It's not even just an affiliate. It could be just someone else that they know who likes and finds the information profitable who then might give them something back in return, such as commissions or business or some other type of information.

The CHAIRMAN. Do you think that's right, Mr. Kanter? Is there no way we can stop these quarterbacks from betting on their own game?

Mr. KANTER. Well, I think that when you're talking about trading on inside corporate information, what Steve is saying is almost akin to saying, hey, it's okay because if someone calls you—and we're talking about misappropriation—it should be made illegal. The trick here is that with the computerization that the flow of market information should be centralized, and that's why the expanded use of the DOT system of the New York Stock Exchange whereby—we are looking at a microcosm of an attrition of 10 years after the abolition of fixed rates, and we're sort of brainwashed to feel this is the way it is. But if in fact the market and the gentle-

men in back of me could get better executions instead of paying 1.9 cents it became .7 cents by in effect having all market participants express what they want to do through a centralized information system, shipping their orders over the DOT system to the New York Stock Exchange in a centralized environment of pricing without the brainwashing that we've been used to in the last ten years of this uneconomical misallocation of resources of the combination of agency and principal transactions by member firm market makers, hey, let's either decide we're going to have an auction market or decide we're going to have a dealer market. But this hybrid system is advantaging those who can advantage the hybrid system but the disadvantaged are the ones that are supposedly participating in an auction market system which is the small investor. The small investor thinks he's dealing in an auction market system. The institutions are dealing in a dealer market system and the dealers are sharing information and advantaging the exhibited bids and offers in the auction market system. That's the problem.

AUTOMATED ORDER MATCH SYSTEMS

The CHAIRMAN. Mr. Wunsch. In your testimony you say that developing automated order match systems in our markets would provide the most complete answer to the frontrunning problem.

In fact you note that Tokyo and Toronto already have such systems and that this is a competitive advantage which will mean the United States is going to lose business. This is a much different story from the many grave warnings to the Committee about potential competitive advantage to domestic markets from regulatory reform.

Could you describe how the automated order match system differs from our markets and why it provides a competitive advantage to overseas markets?

Mr. WUNSCH. I guess the easiest way to describe how the Tokyo market works or the Toronto market works is to think of how the New York market works and make one minor change.

When you come to the opening of the New York Stock Exchange everyone can place their orders on electronic systems such as DOT. The orders all come into a centralized and automated order book that the specialist has and then once the opening price is set the automated bills can go back out to the customers.

Now Tokyo has all of those things but they have one thing in addition to that. The orders that come into the specialists or the equivalent of the specialists—Tokyo has really not—they don't have specialists but they have a clerk who does this function—those orders and what the specialists would see are then distributed to all the member firms electronically so that in effect the order flow situation at the opening of the Tokyo Stock Exchange is broadcast to member firms and could be broadcast to the entire investing public, both individual and institutional.

Now if our system worked like that—in other words, if the New York Stock Exchange were to broadcast the opening order situation prior to opening the market, we would have in effect a total auction what I call single price auction environment which does not rely on any market maker capital.

That's not to say that market makers of every description couldn't participate in it, but the system would just find the price at which any buyers and sellers would like to trade irrespective, and they would not need a market making middleman in-between their trades.

The CHAIRMAN. Is there an advantage in keeping the specialist order book closed?

Mr. WUNSCH. Not that I can think of. There are a number of disadvantages. Probably the greatest one these days is that providing liquidity through market making is an inherently volatile process beginning with those little wriggles between bids and offers and expanding into greater and greater amounts of market impact with larger and larger trades.

Our problem in this country is that our markets are totally dependent on market making for liquidity, whereas foreign markets that have automated order match systems in effect have auctions to get buyers and sellers trading together at the same price without market maker intervention and without the volatility that comes with market making. I believe that October 19th was a good example.

The CHAIRMAN. What has kept us from moving to the Tokyo-Toronto system?

Mr. WUNSCH. Primarily I think it's been resistance from market makers and their representatives on exchanges and dealers.

The CHAIRMAN. Why?

Mr. WUNSCH. Order flow information is the lifeblood of market making and the advantage to a market maker of having information that others don't have is how they make their living. As Mr. Sperandeo described it, it's like a poker game where the rules are that everybody has to show individually their hands to the market maker but they can't show their hands to each other and they can't see the market maker's hand. Obviously the market maker is going to win in a game like that.

The CHAIRMAN. What we want to do is open up that information just as widely and timely as possible. Then we have the best market. Then we have people who may gain through prudence and judgment and that's the way the market ought to operate.

Mr. WUNSCH. That is the only way you can create an efficient auction market, is to have everyone who has an interest in the information able to access that information at least as well as any other party can.

Mr. KANTER. In that regard, I have heard so many negatives about the fact that the specialist book is closed. Well, the specialist book is not what it used to be. I was a specialist for 15 years. At that point it was a greater mix of investor rather than institutional investors, so there was more on the specialist book. Now the specialist books are pretty much coops. Coops, empty coops. There are no orders in the coops. So there's really a fragment of the order flow information that the specialist has. He has a minuscule amount of order flow information.

The order flow information, as Mr. Kirby astutely pointed out, is the dossier that the member firm has on the money manager and his book. So they're sitting there with the order flow information. The poor specialist—bless his heart—is getting picked on for

not opening up his book but meanwhile the member firms have the book. That's the book that has to be brought to the floor into a centralized environment, and only then could that information be distributed to all market participants, from the retail account executive who wants to make a pricing decision on 300 shares of General Motors for a widow or Victor and myself who trade in a "closet" or anybody else who in effect is not disadvantaged by making pricing information without order flow information.

The member firms plus their privileged clients see the book.

The CHAIRMAN. You're an expert and a specialist. Press reports this morning indicate that the chairman of the New York Stock Exchange, John Phalen, and the chairman of the Chicago Merk, Leo Malamed, are close to reaching agreement to halt all trading when the market moves 250 points. One was 200 and one was 300 the other day. The establishment of this circuit breaker merely coddles together a stop-gap measure without coming to grips with the real problem, which is the inadequacy of our present monopolistic system of trading.

Would you not agree that what we really need to do is to replace the specialist system on the New York Stock Exchange with an electronic stock market?

Mr. KANTER. I have done a lot of soul searching in terms of the electronic stock market and, with honesty, it is the perfect system because it gives everyone an ability to trade with everybody else, as Steve has pointed out, without the injection of a dealer who can profit from the difference, manipulate the difference, and cause volatility by the fact that he's aware of both sides or one side of the various orders.

But on the other hand, being a specialist, being an upstairs trader, being a market maker on the floor and, in effect, utilizing a very small electronic system of INTEX, I find very many problems with the adequacy of that system in terms of who can push the buttons, what if a wrong button is pushed, and many, many specific technical aspects.

From the point of view of theory, it's magnificent. It's the answer. From the technical aspects, it would have to be done in a very slow way, phased in, because, as an example, I went to buy an index future and instead of putting in one I put in a hundred. That could move a market. What if someone comes in your office with a gun and starts playing around with the machine?

VALUE OF CIRCUIT BREAKERS

The CHAIRMAN. But I understood you to have great skepticism about the effectiveness and value of circuit breakers under any circumstances.

Mr. KANTER. My personal opinion is that they are detrimental. I think, if anything, from the intelligent people I've spoken to, there is as much on the side of being detrimental than potentially beneficial. The fact that I think they are detrimental, the most important thing in a market is to keep it going because once you have to close it, then fear sets in.

If we were sitting there on October 19th and at 2 p.m. these markets shut, then I think the fear element would have been much,

much greater than existed at the point that they kept these markets going. Shutting down a market is not the answer. Yes, the other side of the coin is that it is in fact a wait where people can gather their thoughts and so forth and so on, but keeping a market going is the greatest strength a market could show.

So I'm not sure which way it can go, but I don't think there's any evidence one way or the other. I have a personal opinion, but I also have a political personal opinion that this is, with all the good intentions of the Brady report—and I honestly feel that they thought it would help—this is nothing in terms of what our problem is with the markets. Even if it works, it means nothing. It's a smokescreen.

The CHAIRMAN. In just a minute or two could you describe both the advantages and disadvantages of the establishment of an electronic stock market?

Mr. KANTER. The advantages would be that the supply and demand evidenced by all market participants will be centralized. Therefore, in today's world, if Mr. Kirby wants to sell 100,000 shares of XYZ, he might call a member firm. They might represent 4 percent of the buying power of the whole street. The electronic stock market I assume would include informational displays whereby he would have the ability, if he thought appropriate, to evidence his order like Steve has very astutely mentioned in several of his articles he's written in several magazines on the basis that evidence in the order, like the public auction of T bills by the United States, is the best way to effect best price. Or he might start feeding his order into the market with seeing the present bids and offers and the size thereof on a continuous basis.

ADVANTAGE OF THE ELECTRONIC STOCK MARKET

The biggest advantage of the electronic stock market is that it exhibits the largest amount of supply and demand in a centralized way, meaning the computer screen, which in fact, because of that fact, will allow Mr. Kirby and myself to trade without a dealer being in the middle who would either increase our costs and/or create volatility because of the fact that he has right of first refusal on orders and could do anything he might want to do, as Victor has suggested, in terms of manipulating with our orders.

The disadvantages are strictly technical. Who is going to push the button? What if the wrong button is pushed? What if someone walked into the office and put a gun to the guy who's operating the machine and says, "Buy a million shares of General Motors." Those are the very large technical aspects which—I'm not a computer person—which I think would have to be overcome. But in general, it is the perfect system if it could be practically organized.

The CHAIRMAN. It sounds to me like on balance it's the best. The prospect of somebody walking into a room and putting a gun to your head and saying "Buy a hundred million shares"——

Mr. MACHOLD. I just would add into this discussion that many institutional investors have been looking at systems to avoid the trading mechanisms. They would trade directly amongst each other, and Instanet is one and Autex is one, Greta Marshal in California has a system where people show her blocks blindly into a

black box and they buy or sell, depending upon what their own objectives are. These systems are evolving independent of the marketplace.

The CHAIRMAN. What's wrong with that?

Mr. MACHOLD. I don't think there's anything wrong with that. I think it's an excellent idea. The difficulty that we have in designing this system is that we are worried about these so-called errors. There is no clearing system that would be perfect without the supervision of some independent party and there is no mechanism for assuring good delivery without the supervision of some independent party. What we have found is that if you have a failure of credit on the other side of your transaction on your black box, who do you appeal to?

So these are the serious issues. I'm not worried about the gun coming in. I'm just worried about the guy who's made a bad trade and wants to walk away from it on the other side of the issue and there's no supervisory body or nobody can guarantee his trade in between.

The CHAIRMAN. Do you agree with that, Mr. Kirby?

Mr. KIRBY. Yes. Ideally, as everybody has pointed out, a system whereby you get rid of people making a profit in the middle, a nationwide market based on a central computer and everyone having access to it, would be the solution. But, again, you need all the clearing mechanisms to ensure the financial integrity of the transaction, which is not easy to do.

The Chairman. Well, gentlemen, thank you very much. Thank you for your excellent testimony.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

84-767 (72)